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Access to Credit and Capital Among

*Minority-Owned Businesses**

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by

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**Testimony prepared for the U.S. House of Representatives Committee on Small Business,
Subcommittee on Minority Enterprise, Finance, and Urban Development.*

*Research reported in this testimony was conducted on-site at the Center for Economic Studies,
U.S. Bureau of the Census. Conclusions expressed are the author's and do not necessarily reflect
the views of the Census Bureau.*

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Testimony of Dr. Timothy Bates before the U.S. House of Representatives Committee on Small Business, Subcommittee on Minority Enterprise, Finance, and Urban Development

Topic: Access to credit and capital among minority-owned businesses.

A. Envision two entrepreneurs starting small businesses:

- 1. Both are college graduates;*
- 2. Both are 40 year old males;*
- 3. Both have 18 years of managerial work experience;*
- 4. Both are investing \$30,000 of their own personal funds (equity capital) into their business startup;*
- 5. One is African American, the other is white.*

Do these two entrepreneurs have equal access to loan funds from financial institutions?

No - not even close. My examination of 2,133 actual bank loan recipients (1419 white, 714 black) shows that, controlling for education, work experience, age, gender, and other factors, bank loan dollars, per dollar of owner equity investment, are:

White firms: \$ 1.85

Black firms: \$ 1.16

B. Loan Access

Table one summarizes nationwide data comparing debt financing used by African American and white owners creating small businesses. At startup, the average white-owned firm has more than twice as much financial capital (\$70,756 among those using debt financing) as

Table One: Financial Capital, Debt Capital, and Loan Incidence Among Young Firms, by Owner Race

	<u>Borrowers Only</u>		<u>Nonborrowers Only</u>	
	<i>Black firms</i>	<i>White firms</i>	<i>Black firms</i>	<i>White firms</i>
<i>Total financial capital (mean)</i>	\$32,813	\$70,756	\$8,545	\$22,692
<i>Debt capital (mean)</i>	\$22,079	\$48,684	-	-
<i>Percent receiving bank loans</i>	55.6%	64.6%	-	-

Source: U.S. Bureau of the Census Characteristics of Business Owners Data Base

the average black business (\$32,813). Financial institutions are the largest source of debt capital for these firms: among the startups utilizing debt, 64.6 percent of the white firms and 55.6 percent of the black firms borrowed from banks (table one). Many of these loans are not formal business loans, which are not attainable for many business startups. Other common types of bank loans that are widely used are 1) personal loans, 2) home equity loans, 3) overdraft accounts, and 4) credit cards. These various bank loans provide more loan dollars to small business startups than all other sources combined. Table two extracts the bank loan recipients only from table one's data. Note that among bank loan recipients starting small businesses, average loan sizes are:

White firms: \$55,803

Black firms: \$25,704

African American firms are much more likely to utilize personal loans, overdraft accounts, and credit card balances to finance business entry. Percentages of bank loan recipients borrowing less than \$5,000 are:

White firms: 24.6%

Black firms: 43.1%

Thus, black business borrowers more often use sources of consumer credit - smaller, generally more expensive loans - while whites use business loans more frequently to finance small business creation.

C. Why are Black Business Borrowers Coming Up Short?

There are three main reasons; the average African American starting a business, relative to white owners:

Table Two: Financial Capital Structure of Borrowers**Bank Loan Recipients Only**

	<i>Black Firms</i>	<i>White Firms</i>
Total financial capital at time of entry		
Mean	\$36,530	\$76,318
Percent under \$10,000	47.2%	27.7%
Equity		
Mean	\$10,826	\$20,514
Percent under \$5,000	66.1%	52.8%
Debt		
Mean	\$25,704	\$55,803
Percent under \$5,000	43.1%	24.6%

Source: U.S. Bureau of the Census Characteristics of Business Owners Data Base

- 1) has less equity to invest;
- 2) receives fewer loan dollars per dollar of equity investment;
- 3) is less likely to have affluent family members or friends that provide alternative loan sources.

Thus, the problem of low equity, which is rooted in low household wealth accumulation, is exacerbated by limited ability to leverage what equity the African American owner brings to the table.

Household wealth is a very important source of funds for starting small businesses. In terms of marketable household wealth holdings - financial assets, real estate, and the like - my studies reveal that 4.2 percent of black households and 22.1 percent of white households have net assets exceeding \$100,000. Median marketable wealth among black households is \$5107, versus \$37,999 among whites. Having less equity to leverage makes bank credit less accessible. Furthermore, family and friends are the second and third largest debt sources for small businesses. Paucity of wealth makes family and friends a weaker debt source for blacks than for whites. Lower black household wealth holdings are rooted in both lower incomes and general lack of intergenerational wealth.

D. What Can be Done?

In summary, all three major debt sources - financial institutions, family, and friends - provide more credit to white than to black business owners. Problems of lower incomes and intergenerational wealth cannot be altered quickly. The inferior treatment accorded black entrepreneurs by commercial banks can be acted upon. Studies of financial institution lending discrimination invariably focus upon housing finance. The rich small business data resources

described in this report have been available at the Census Bureau since 1988. I am the only person in the country who has analyzed these data extensively: no person from the FDIC, the Fed, or the Comptroller's office has taken the time to study bank treatment of minority-owned business comprehensively. A first step is to call attention to the problem and to pressure the bank regulatory agencies to pay more attention to bank treatment of minority entrepreneurs.

E. Other observations

- 1. Are all minority groups equally effected by capital asset problems? No. Asian-Americans are, on average, better educated, wealthier, and higher income than whites. Their business financing problems are altogether different.*
- 2. What kinds of industries are minorities most likely to be shut out of by capital constraints? Capital intensive ones, of course. Manufacturing is the most capital intensive major line of small business: African American representation in manufacturing ownership is much lower than in other fields, Their representation in communications is so low that I could not even generate meaningful summary statistics on minority underrepresentation. Minority representation in capital-intensive emerging industries, in the absence of specific government intervention, is going to be high only among Asian Americans. Minorities generally and African Americans specifically are largely shut out by financial capital barriers, which force them to favor self-employment in less capital intensive service industries.*